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Intelligence Memorandum

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Secret
ER IM 74-10
August 1974

Copy Nº 89

Approved For Release 2000/04/18 : CIA-RDP85T00875R001700070010-2

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Classified by 015319
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§ 5B(1), (2), and (3)
Automatically declassified on:
date impossible to determine

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Chile: The Junta Struggles for Economic Recovery

The junta that ousted Allende last September moved rapidly to restore economic order, increase production, and halt Allende's socialization program.

- Almost all price controls were removed to encourage domestic industrial production, and programs were initiated to increase agricultural output.
- A stabilization program was instituted to cut the budget deficit and reduce the growth in the money supply.
- Wage increases were restricted, and strict labor discipline imposed, particularly in the copper mines.
- The escudo was devalued.
- Many expropriated firms were scheduled for return to their former owners.
- Compensation was arranged for Cerro and Anaconda corporations, and negotiations continue with Kennecott.
- A repayment formula was negotiated with Chile's chief foreign creditors.

The junta's most dramatic showing occurred in the copper industry, where record output and high world prices are combining to give Chile its best external payments position since 1970. Record export earnings will more than offset the outlays for high-priced imported oil and food in 1974.

In contrast to the improved external economic outlook, domestic economic difficulties continue to confound the regime. Inflation, though more constrained than during Allende's last year, still is unmanageable. Incomes have failed to keep pace with prices, causing demand to decline and industrial output to stagnate. The

Note: Comments and queries regarding this memorandum are welcomed. They may be directed to [redacted] of the Office of Economic Research, Code 143, [redacted]

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economic slowdown is hitting the poor and the workers the hardest and is causing friction within the junta over economic policy. The free market policies pursued by the junta's civilian economic advisers have been attacked by military advisers who advocate greater attention to political considerations in economic policymaking. These differences are not yet critical, but, if inflation is not soon brought under control, the split could deepen and public disaffection could grow.

DISCUSSION

Introduction

1. In power since September 1973, the Chilean junta is still struggling to devise an effective economic recovery program. It has, for the most part, relied heavily on a group of orthodox economists – the "Technocrats," or "Chicago Boys"[1] – who have pressed policies emphasizing free markets, tight money, reduced budgetary deficits, economic decentralization, and dependence on private investment. These policies have created hardships for a substantial part of the population, particularly the poor, and have caused dissension within the regime.

The Allende Legacy

2. The junta that seized power last September inherited an economy in shambles. Manufacturing during January-September was 8% below the 1972 level (see Table 1); copper output was off 10%. Agricultural production had declined

Table 1

Chile: Changes in Real Gross Domestic Product, by Sector of Origin

Percent

	1970	1971	1972	1973[1] Jan-Sep	1973[1] Jan-Dec
Gross domestic product	3.7	8.3	1.6	-9.3	-5.6
Agriculture, forestry, and fishing	7.8	5.1	-3.6	-20.0	-16.1
Mining and quarrying	1.0	1.7	-6.5	-30.0	0.6
Manufacturing	1.3	12.9	3.1	-8.0	-4.3
Construction	2.7	9.6	-10.6	-30.0	-28.1
Services	4.9	7.9	4.6	-2.0	-1.7

1. Estimated.

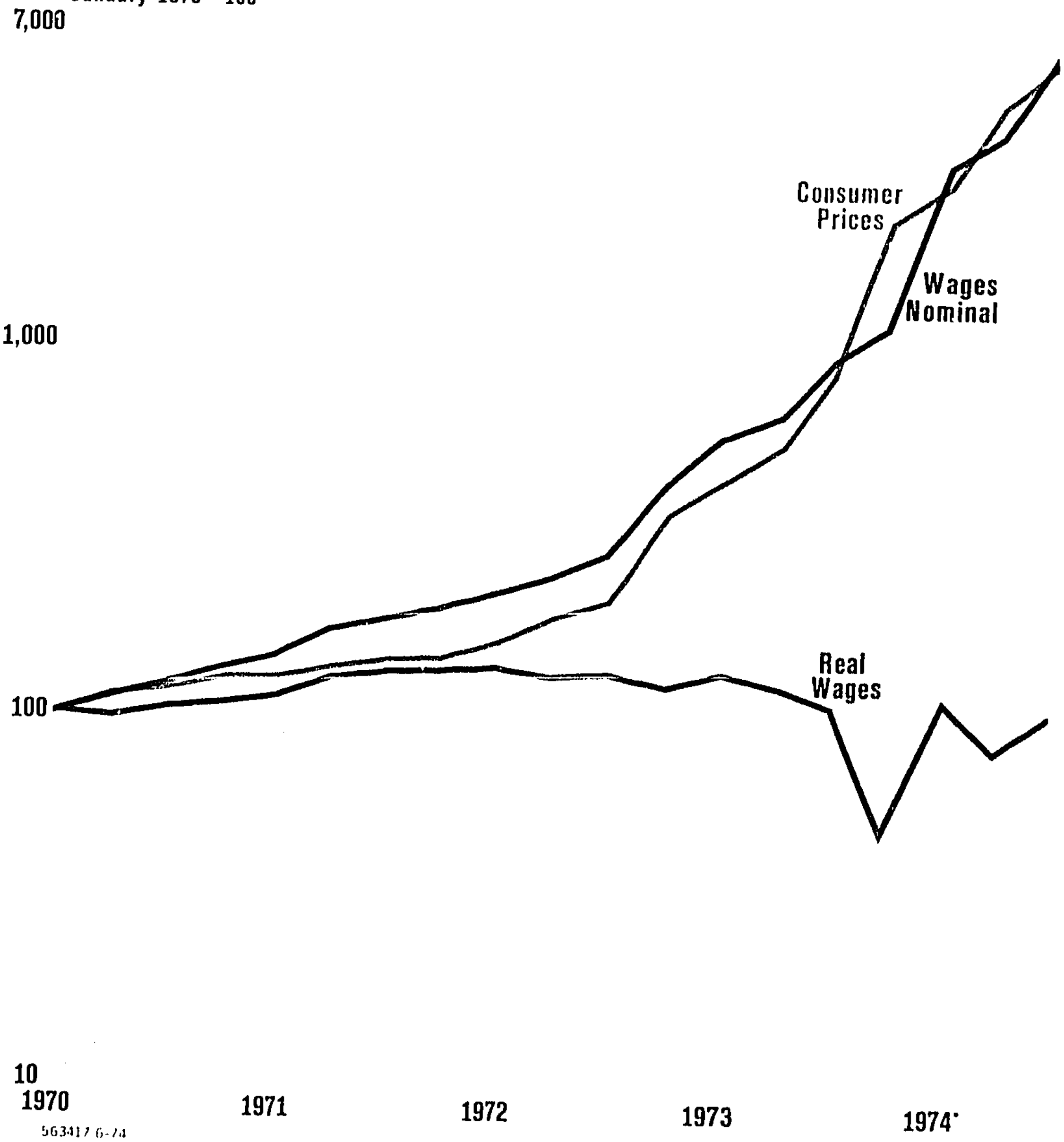
20% because of mismanagement of the dominant state-controlled sector. Cereal production had fallen about 30% since 1971, and output of such key crops as wheat, barley, and sugar beets had dropped between 23% and 38% below 1972 levels. The nations's dairy herds had been drastically reduced because of low dairy prices. Food imports in 1973 reached a record US $540 million.

1. So known because they were educated at the University of Chicago.

3. Inflation was out of control. By the time of the September coup, Allende's dependence on the Central Bank to finance his social and development programs had caused the money supply to balloon 1,400% during three years. Prices had rocketed nearly 1,100%, outstripping wage increases of 850%; real wages fell to 80% of the pre-Allende level (see Figure 1). Consequently, in spite of bloated employment, personal consumption was falling in 1973, following substantial increases in 1970-72. Investment, which had already been squeezed, fell even more, and private investment virtually ceased.

CHILE: Price and Wage Trends Figure 1

January 1970=100



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4. A more rapid increase in consumption than in GNP not only squeezed investment but also resulted in large foreign trade deficits, which grew from 2% of GDP in 1970 to 6% in 1973. Foreign exchange reserves virtually disappeared, and external debt rose to nearly $4 billion.

Efforts at Recovery

5. By the time of Allende's ouster, shortages of most consumer goods had become acute, the distribution system had broken down, and a general economic paralysis had begun to set in. The new regime moved rapidly to restore economic order and return a large part of domestic production and distribution facilities to the private sector. Price controls were removed from all but 30 basic commodities and higher prices were fixed on controlled items in an effort to stimulate production. Prices jumped immediately, bringing goods that had been available only on the black market into shops and normal distribution networks. The termination of a disastrous truckers' strike also released stocks stored in warehouses and cut backlogs at the ports. The consolidation of internal security brought labor disruptions to an end, leading to a marked recovery of industrial production and mining. The continuing rise in prices, coupled with lagging income, however, quickly led to unsalable inventories and to slight declines in industrial production during the last two months of the year.

6. The International Monetary Fund helped formulate a stabilization program as a condition for IMF standby credits. The consultations resulted in a 1974 budget target that called for a deficit equal to 6% of expenditures, compared with the 52% overrun in 1973. The official budget, however, called for a deficit equal to 23% of expenditures – outlays of $4.3 billion and revenues of $3.3 billion.

7. Fiscal planners have adopted new taxes on capital and income, but returns thus far have been disappointing and probably will not equal the planned $200 million. Santiago had hoped to save some $1.5 billion by returning many nationalized and intervened firms to the private sector and reducing subsidies to state utilities. Stern state regulations on reversion, combined with the poor financial condition of many firms, however, have dashed these hopes. Moreover, public sector enterprises are not meeting budget targets, and they face a possible spending moratorium in the last quarter of 1974. Despite efforts to reduce spending, the deficit is expected to widen as wage and price increases continue to exceed targets. Total expenditures could exceed $5 billion against revenues of $3 billion, leaving a deficit of about 40%.

Reversion of Private Industry

8. As a first step in reducing the role of the public sector, the junta scheduled the return to private ownership of some 400 nationalized firms, about one-half of which were largely foreign-owned. The erstwhile US-owned copper companies were not included. Agreements have been reached for the return of

14 textile firms – accounting for about one-half of the industry's capacity – and nearly 200 other firms, including at least 16 US subsidiaries. Reversion is limited to those companies that had their properties "unlawfully or illegally taken" and excludes those that sold out or consented to takeover.

9. In order to reacquire their companies, former owners must agree to accept the debts incurred during nationalization, waive any claims against the government for damage to facilities, rebuild and expand the firms, and avoid wholesale labor dismissals. Moreover, the reemerging owners must agree to a yet-to-be-issued labor relations decree that may include provisions for worker participation in management and limits on the owners' freedom to hire and fire.

10. The junta has adopted a new Foreign Investment Code designed to attract foreign capital. New investment will be channeled through the Committee for Foreign Investment under contracts of 10-20 years' duration. These accords will spell out exchange rates and repatriation, tax, and other rules applying to each investment. Foreign investment ostensibly will be treated equally with domestic investment. Investment in existing "national enterprises" will be permitted on a selective basis generally up to 20% of existing equity.

Production

11. Initial efforts to stimulate production consisted largely of imposing strict labor discipline with threats of force and dismissals. The workweek was increased from 44 to 48 hours, and Allende's labor-padding policies were largely discontinued. Industrial production in October rose about 25% over the severely depressed August level (see Table 2 and Figure 2). This sharp rise in output stemmed from various factors. Production of goods in different stages of processing was accelerated as

Table 2

Chile: Quarterly Index of Industrial Production

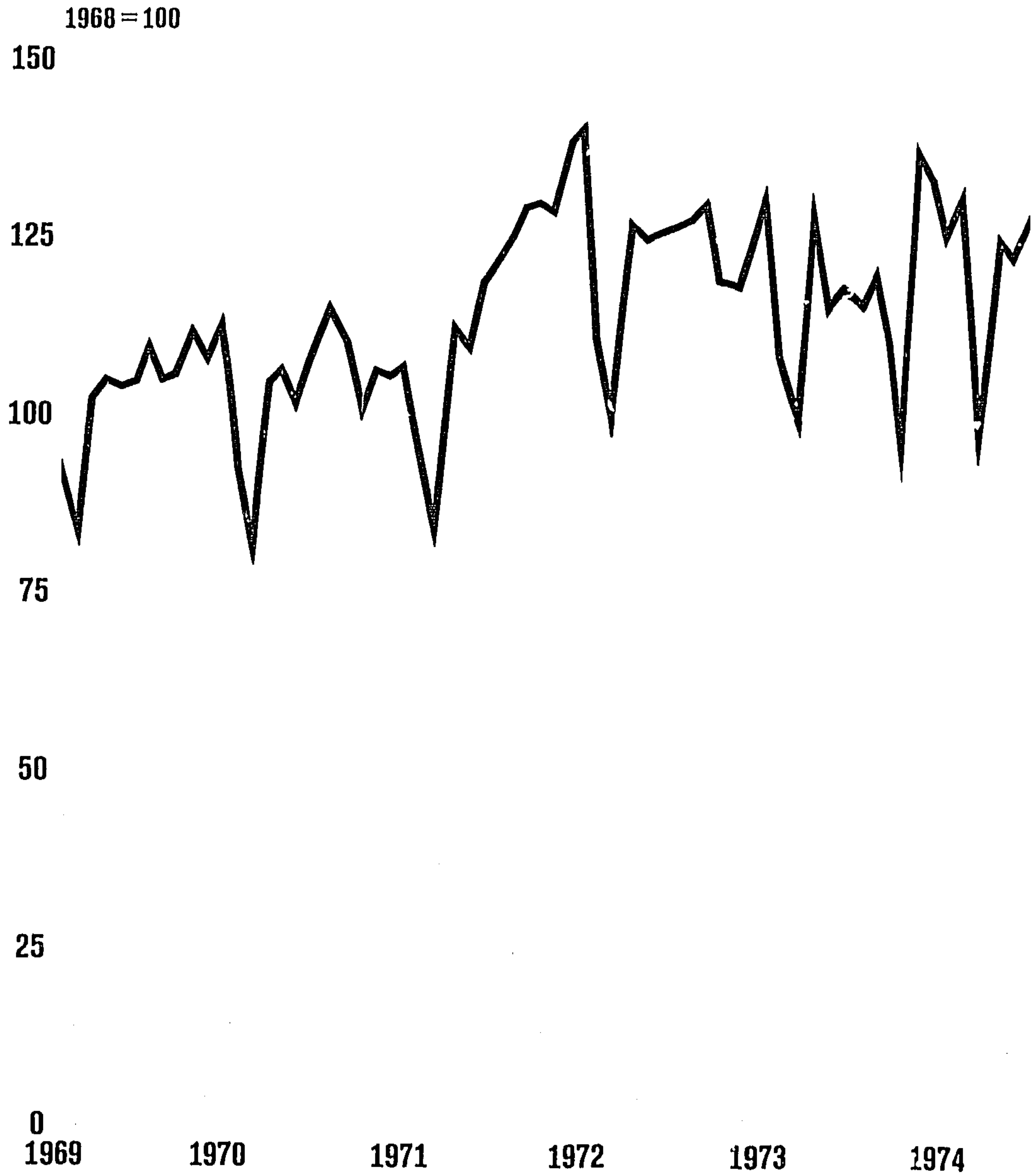
1968 = 100

	1969	1970	1971	1972	1973	1974
Annual average	104	104	119	123	117	125[1]
1st qtr	93	92	96	112	113	119[2]
2d qtr	105	106	117	126	117	127[2]
3d qtr	107	109	128	126	108	
4th qtr	111	107	136	126	132	

1. Projected.
2. Estimated.

Figure 2

CHILE: Industrial Production



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transportation and labor bottlenecks were eliminated. The removal of price controls generated a rapid drawdown of inventories hoarded in anticipation of higher prices. The imposition of labor discipline sharply reduced absenteeism, which in many cases had exceeded 20%. The extension of the workweek added another 10% to production time. Pilferage of goods for sale on the black market – which reduced production in some consumer goods industries by more than 25% – was curbed by the presence of soldiers in many plants and the elimination of the black market.

12. The return of labor discipline, although bringing about a sharp recovery of output, could not sustain continued growth. Indeed, the laying off of surplus workers, combined with declining real wages, held down consumer demand. Consequently, output in November-December fell about 10%, recovered only slightly in January 1974, and dropped sharply in February.

13. The copper industry has shown the most dramatic recovery. Average monthly mine production jumped nearly 30,000 metric tons during the last quarter of 1973 (see Table 3). Total production, 736,000 tons in 1973, may reach 900,000

Table 3

Chile: Copper Production

Thousand Metric Tons

	Major Mines	Small and Medium Mines	Total
1970	541	151	692
1971[1]	571	137	708
1972	593	129	722
1973	616	120	736
Monthly average			
Jan-Sep	45	9	54
Oct-Dec	70	13	83
1974[2]	770	130	900
Jan-Jun	64	N.A.	N.A.
1975[2]	800	150	950

1. The assets of the five large copper mines were nationalized in July 1971.
2. Projected.

tons in 1974 and 950,000 tons in 1975 as the damage to smelters and refineries is repaired. The surge in output is due to (1) labor stability accompanying official guarantees of food, clothing, and other necessities and warnings that workers risk being shot if they fail to work; (2) replacement of political appointees with skilled management; (3) new government spending to relieve most shortages of parts and vehicles; and (4) more effective use of some $600 million worth of new facilities built just prior to Allende's takeover of the industry.

14. Although no formal development plan exists, Chile hopes to expand its present copper production capacity of 1 million tons per year to 1.5 million tons during the next five years. This goal can be achieved only with major imports of foreign capital and technical assistance. Since the copper industry will remain under state control, such assistance will have to be acquired under management and technical assistance contracts and loans repayable in kind.

15. Chile's ability to attract further US participation depends to a large extent on the compensation agreements for properties Allende expropriated. Cerro Corporation, which remained in Chile under contract after nationalization, settled for $3.2 million in cash and $38.6 million in bonds repayable over 17 years. Redemption of the bonds with copper equivalent can be accelerated if output from the Andina mine is expanded rapidly. Cerro has contracted to double the mine's production by 1975. A recent settlement with Anaconda calls for a cash payment of $65 million and a $188 million note repayable in 10 years at 10% interest. Negotiations with Kennecott continue.

16. Many foreign firms have bid on copper development projects in Chile. A consortium of firms from Belgium, Brazil, Finland, France, and West Germany extended Chile a $140 million credit to expand small and medium mining enterprises. The junta also is soliciting private capital to develop the El Abra deposits in northern Chile at an estimated cost of $450 million. Assistance probably will be sought in developing recently discovered deposits in the Elqui Valley, which could eventually yield up to 500,000 tons of refined copper per year. By the early 1980s, Chile could have an additional 400,000 to 500,000 tons of copper production capacity.

17. More pressing than opening new mines is expanding the processing and smelting capacity from the present 850,000 tons to 1.1 million tons. The extra capacity is needed to counter periodic downtime on smelters for relining, cut transportation costs, and eliminate exports of low-value concentrates. Most of the immediate expansion – about 90,000 tons by the end of 1975 – is planned for the Chuquicamata and Exotica mines.

Agriculture

18. The planting season for most major crops was over when the new regime assumed power. Cereal production from the 1973/74 harvest registered little increase over the poor crop of the previous year (see Table 4), as a 31% jump in area harvested barely offset a 22% drop in yields due to poor management and late planting. Consequently, the country still faces food shortages and may have to import $650 million worth of food in 1974.

19. Government efforts are expected to lead to higher agricultural production and lower food imports in 1975. Cereal production in 1974/75 is expected to increase more than 20% because of price incentives and expanded use of quality seed and fertilizer.[2] The Inter-American Development Bank (IDB) has provided a $22 million loan for seed, fertilizer, insecticide, and equipment. This aid is crucial since poor crops and low returns to agriculture depleted seed supplies, and poor

2. Original estimates projected an increase of about 35%. However, heavy storms disrupted planting of about two-thirds of the winter wheat crop and destroyed part of the crop that had been planted.

Table 4

Chile: Cereal Production[1]

Crop Year	Area Harvested (Thousand Acres)	Yield (Kilograms per Acre)	Production (Thousand Metric Tons)
Annual average			
1960/61-1964/65	2,459	628	1,543
1965/66-1969/70	2,422	760	1,841
1970/71	2,392	807	1,931
1971/72	2,427	615	1,493
1972/73	1,937	681	1,320
1973/74[2]	2,538	534	1,355
1974/75[3]	2,300	715-720	1,650

1. Wheat, corn, rye, rice, barley, and oats.
2. Estimated.
3. Projected.

managment caused fertilizer production to drop from 2.5 million tons in 1970 to 800,000 tons in 1973. The government also is reorganizing and expanding farm credit facilities and is encouraging private firms to compete with government marketing cooperatives by making more credit available. About $125 million in government credits will be available in the second half of 1974. Meat production, which hit a low of 170,000 tons in 1972 because of weak price incentives, is expected to increase 13% this year to 207,000 tons. Full agricultural recovery, however, is not expected for at least two years.

20. Initially, the junta appeared to be continuing the agrarian reform program. In December, titles were granted to some 7,200 families working 300 farms legally expropriated by the Allende regime. The pace of official acquisitions subsequently slowed when the Agrarian Reform Law was amended to prohibit expropriation of holdings of 100 acres or less. The restriction has now been raised to 200 acres, essentially halting further takeovers, since the largest holdings were the first to be taken by Allende.

Devaluation

21. The new regime has gradually devalued the escudo to roughly 6% of its former dollar value and simplified Chile's cumbersome multiple exchange rate system. A Banker's Rate for trade transactions and a Broker's Rate for tourists replaced the complex structure used by the Allende regime to subsidize consumer imports while taxing exports. Under Allende the average effective exchange rate for imports had been 67.5 escudos per dollar, with food imports negotiated at

25 to 1, copper exports at 13 to 1, and other exports at an average rate of about 100 to 1. Exchange rates in early August 1974 stood at 860 to 1 for trade (except copper exports) and 950 to 1 for tourists. These rates are effectively unified since taxes on foreign exchange transactions bring both rates to about 1,070 escudos per dollar. Copper from the major mines continues to be exported at a lower rate than other goods, 550 to 1. Nevertheless, this is a much more profitable rate than under Allende.

Money Supply

22. Despite efforts to reduce spending and curb inflation, Chile's money supply (money plus quasi-money) grew about 155% during the last quarter of 1973, bringing monetary expansion for the year to 450%. The private sector accounted for more than 60% of the 1973 increase. Adding to the problem was the increase in the velocity of money (estimated at about 35%). Velocity continued to grow in the first quarter of 1974 as inflationary expectations made the holding of escudos unattractive. The junta has sought to gain more control over monetary expansion through reorganizing the banking system, limiting deficit spending, and curbing the expansion of credit in the private sector. Although the junta's planned 15% cut in public sector outlay and 20% cut in public sector employment could shave some $700 million off the current deficit, other measures such as higher taxes and improved savings instruments will be needed to curb the growth in money supply and velocity.

Prices, Wages, and the Erosion of Incomes

23. Abandonment of price controls under the junta hit the poor hard. Consumer prices jumped nearly 110% in the last quarter of 1973, bringing inflation to about 710% for the year.[3] Prices advanced another 145% during the first half of 1974, dashing hopes for holding increases to 200% for the year. The extraordinarily high rate of inflation stems largely from the surge in world prices of imported petroleum and agricultural goods reinforced by the sixteenfold exchange devaluation. Continuation of the January-June rate would generate price increases of 500% for 1974. Even if the junta is able to cut the inflation rate by one-half to about 8.5% per month, the cumulative price rises still will reach 300%.

24. To help offset the impact of spiraling prices, the junta granted wage increases in January averaging 55%; in May, 30%; and in July, more than 20%. Cost of living bonuses also have been granted to the poorest workers. Despite these increases, real wages still are about 7% lower than last January. The poor have managed to maintain their position because of the bonuses. Higher income groups have suffered the largest erosion, with reduction in family purchasing power of 25% or more.

3. The junta adopted a new price index in January designed to better reflect changes in consumer purchasing power. According to the previous index, prices in 1973 rose 508%.

The Formulation of Economic Policy

25. Santiago's difficulties in coping with inflation and the constant deterioration of workers' real incomes have led to a disagreement within the junta. The Committee of Advisers to the Junta (COAJ) – a body comprising military officers – has disagreed with the orthodox, free enterprise policies employed by Minister of Economy Fernando Leniz and junta economic adviser Raul Saez. General Cannessa of the COAJ and later Admiral Merino of the junta – previously a strong supporter of the orthodox approach – seek to give more weight to political and social considerations in the formulation of economic policy. As a result, the National Development Corporation (CORFO), with the support of the COAJ, has dragged its feet in returning businesses expropriated by Allende. Although President Pinochet has moved with expanded subsidies and bonuses to soften the impact of austerity on the poorer sectors, he continues to follow the orthodox Leniz-Saez economic game plan and has elevated Saez to economic czar as head of the newly created Ministry of Coordination.

26. In his new post, Saez, who was originally responsible for Leniz's appointment to the Ministry of Economy, will coordinate the economic policy aspects of the Ministries of Finance, Economy, Mines, Agriculture, and Transportation and the National Planning Office (ODEPLAN). This centralization of economic policymaking, together with the retention of Leniz as Minister of Economy and the appointment of Jorge Cauas (former Vice-President of the Central Bank) as Minister of Finance, consolidates a competent team of economic administrators. These reorganizations and shifts in personnel portend continuation of the government's current austerity program, rapid denationalization of expropriated firms, and encouragement of foreign investment. Although COAJ continues to function as an advisory body, policymaking is now firmly centralized in the hands of civilian administrators.

The Outlook for 1974

27. Chile's economy should experience a modest recovery in 1974 despite continuing economic difficulties. High world copper prices, improved profits, and restored productive capacity should boost GDP by 6%-7%. Manufacturing output should increase 8%-10% above 1973's depressed level, mining will increase 20%-25%, and construction about 12%-15%. Services – the largest component in Chile's national accounts – will rise slowly because of the junta's desocialization and reorganization of government services. Except for copper, however, these growth rates represent only a partial recovery from the declines of 1973 and will leave output below the 1970-71 levels. They are a product of the return of labor stability.

28. Inflation will continue to threaten economic and political stability. Prices probably will jump more than 300% this year. Higher prices for imported food and petroleum and reduced subsidies on consumer goods are combining to further erode worker purchasing power. Although nominal wage increases in 1974 probably

will exceed 300%, real wages are expected to drop further. The erosion of real wages is being accompanied by an even more serious deterioration of real family incomes because of reduced employment. Unemployment is officially listed at more than 9%, the highest in 15 years. And this does not include a much larger figure for underemployment. A 10%-15% jobless rate by the end of the year is likely, with little prospect for improvement in 1975. The resulting reduction in effective demand will be the chief constraint on the growth of industrial output.

29. Despite estimated outlays of $1 billion for food and fuel imports this year, copper earnings of more than $1.6 billion should give Chile its best trade and payments balance since 1970. The 1974 trade deficit is projected at $220 million, and the current account deficit at $430 million. With some $470 million of debt rescheduled and $474 million in credits, Santiago's payments will register a deficit of about $50 million (see Table 5).

30. The projection of 1974 copper earnings assumes output of 900,000 tons, exports of 850,000 tons, an average 1974 London Metal Exchange (LME) price of $0.98 per pound, an average f.o.b. price of $0.88. The average LME price for the first half of the year was $1.17, and prices during the second half are expected to average around $0.80. The expected decline in copper prices assumes (1) slowed world industrial activity that lowers demand for primary products, (2) no prolonged strike in the US copper industry, (3) continued rebuilding of LME refined copper stocks, and (4) maintenance of lower copper inventories by industrial consumers because of high interest rates and uncertain growth prospects.

31. The junta had moved rapidly to reestablish Chile's creditworthiness in the aftermath of the coup. Only an estimated $160 million was paid in 1973 on $518 million of scheduled payments (see Table 6). More than $740 million was due in 1974, including about $325 million carried over from 1973. When it became obvious that Santiago could not make the payments, Chile's major Western creditors – the Paris Club – agreed in March to reschedule 95% of Chile's renegotiable debt. The master agreement calls for payment of 5% of the rescheduled debt this year, 5% in 1975, 10% in 1976, and the balance during the following seven years. Depending on the outcome of the various bilateral agreements, Chile will pay about $270 million (including $80 million of non-rescheduled principal) in 1974. About 60% of some $100 million owed to other creditors, largely Communist nations and international institutions, has not yet been rescheduled.

32. Chile's trade and payments prospects in 1975 depend on continued high prices for copper and recovery of agricultural production. If copper output reaches 950,000 tons, exports amount to 900,000 tons, and LME copper prices average $0.85 per pound, copper earnings would be reduced to under $1.5 billion. This loss would be nearly offset if improved agricultural production is able to cut Santiago's food import bill by 25% to about $500 million. An average LME price of $0.80, however, would result in a net loss of $100 million. Even with good copper prices, Chile will require private capital inflows of about $50 million, official inflows of about $400 million, and another round of debt relief.

Table 5

Chile: Balance of Payments, 1974

	Million US $
Exports (f.o.b.)	1,980
Copper	1,650
Other mining	110
Agriculture and fishing	30
Industrial products	190
Imports (c.i.f.)	2,200
Foodstuffs	650
Fuels and lubricants	350
Capital goods	400
Other	800
Trade balance	-220
Net services and transfers[1]	-210
Current account balance	-430
Private capital (net)	30
Public sector capital (net)[2]	350
Capital inflows	474
Government to government	135
International organizations	154
International banking consortia	150
Consortium mining loan	35
Debt amortization	-594
Debt relief	470
Paris Club	425
Other	45
Capital account balance	380
Reserve movements (increase +)	-50

1. Including $148 million worth of interest payments on the external debt.
2. Projected 1974 drawings. The consortium mining loan is a joint development credit from Belgium, Brazil, Finland, France, and West Germany for $140 million. Application for some $75 million in PL-480 assistance is not reflected in projected drawings.

Table 6

Chile: Summary of External Debt Service Payments

Million US $

	Paris Club Countries					
	United States	Other Member Countries	Total	International Institutions	Other	Total
1973						
Debt service payments due	240.2	213.9	454.1	29.7	34.4	518.2
Estimated payments	37.6	78.8	116.4	21.7	22.3	160.4
Debt relief	202.6	135.1	337.7	8.0	12.1	357.8
1974						
Debt service payments due	314.9	326.1	641.0	39.3	61.9	742.2
Carried over from 1973	170.2[1]	135.1	305.3	8.0	12.1	325.4
Falling due in 1974	144.7	191.0	335.7	31.3	49.8	416.8
Projected payments	....	....	216.0	56.2		272.2
Debt relief	....	...	425.0	45.0		470.0

1. Excluding $32.4 million previously renegotiated with US banks.